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May 20, 2008

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The Honorable Anne K. Quinlan
Acting Secretary
Surface Transportation Board
395 E Street, N.W.
Washington, DC 20423-0001

Re: STB Ex Parte No. 679, Petition of the Association of American Railroads to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology to Determine Railroad Revenue Adequacy

Dear Secretary Quinlan:

Enclosed for filing in the above-referenced proceeding is the Reply of Edison Electric Institute in opposition to the Petition filed by the Association of American Railroads on May 1, 2008 in the above-referenced proceeding.

Very truly yours,

Michael F. McBride

Michael F. McBride
Attorney for Edison Electric Institute

SURFACE TRANSPORTATION BOARD

Ex Parte No. 679

ON "PETITION OF THE ASSOCIATION OF AMERICAN RAILROADS TO INSTITUTE A RULEMAKING PROCEEDING TO ADOPT A REPLACEMENT COST METHODOLOGY TO DETERMINE RAILROAD REVENUE ADEQUACY"

REPLY OF EDISON ELECTRIC INSTITUTE IN OPPOSITION TO THE PETITION

Edison Electric Institute ("EEI") hereby replies in opposition to the "Petition of the Association of American Railroads to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology to Determine Revenue Adequacy" ("Railroads' Petition") filed with the Surface Transportation Board ("STB" or "Board") on May 1, 2008.

Interest of EEI

EEI is the association of U.S. shareholder-owned electric companies. Its members serve 95% of the ultimate customers in the shareholder-owned segment of the industry, and represent approximately 70% of the U.S. electric power industry. It also has as Affiliate members more than 65 International electric companies and, as Associate members, more than 170 industry suppliers and related organizations. The electric industry depends on the Nation's railroads to transport approximately 70% of the Nation's electricity. Therefore, railroad service is vital to assuring that sufficient electricity is generated to meet the Nation's ever-growing demand for it.

Although much of the rail transportation provided to EEI's members is provided under contract, EEI members do, from time to time, invoke their right to have a railroad publish a common carriage (*i.e.*, tariff) rate, in order to seek relief from this Board. EEI members do so not only because the involved railroad possesses market power, but also because the EEI member believes that the common carriage rate quoted by the rail carrier is not "reasonable" within the meaning of 49 U.S.C. §§ 10701 and 10707. In such rate-reasonableness proceedings, ostensibly the Board is required to determine if the railroad defendant(s) is earning adequate revenues. *Id.* at § 10704(a)(1).[1]

The Railroads' Petition is, then, of great importance to EEI and its member companies because it may lead to STB findings that Railroads are not earning adequate revenues, findings that will then be relied on by the Railroads to defend still-higher rail rates. Petition at 36, Table 1 (showing that, under the Railroads' proposed methodology, to be adequate rail revenues would have to increase by more than $17 billion, just for the four large coal-carrying Railroads).

The Railroads' Petition

The Railroads seek to have the Board institute a rulemaking proceeding to consider using replacement costs rather than net investment to value the Railroads' assets in making determinations of railroad revenue adequacy. The Railroads claim that the only appropriate means of valuing their assets is replacement costs, and that they have developed a feasible means of making such valuations. They admit that the result of their Petition, if granted, would be to greatly *reduce* the apparent annual returns on investment calculated by the Board. Petition at 36, Table 1. What the Railroads do not say is that, if the Board were to adopt the approach they advocate, the allegedly inadequate returns that the Railroads would then supposedly be earning would be relied on by them to charge even higher rates.

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[1] However, if the rate exceeds the SAC level, it is "unreasonable" under *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), *aff'd sub nom. Conrail v. United States*, 812 F.2d 1444 (3rd Cir. 1987), even if the railroad is revenue-inadequate.

But shippers have already experienced higher rates, and rate increases, for several years The Railroads' Petition would virtually guarantee that the shippers would experience such higher rates, and still more rate increases, for many years to come.

Summary of EEI's Position

The Railroads have proposed that the Board institute a rulemaking proceeding, and to propose a fundamental change in the ICC/STB's longstanding methodology for valuing railroad assets prudently employed in operations subject to the jurisdiction of the STB. The Petition is based on speculative, hypothetical, and unproven values for such assets, supposedly representing the replacement costs of those assets, and which will require costly, complex annual proceedings to review both the assets to be included and the value of those assets. The ICC previously considered these issues and concluded, rightly, that such a process, while theoretically desirable, is simply unworkable and impractical. *Standards for Railroad Revenue Adequacy,* Ex Parte No. 393 (Sub-No. 1), 3 I.C.C.2d 261, 277 (1986)("While current cost accounting is theoretically preferable to original cost valuation, it cannot be practically implemented in a manner that we can be confident would produce accurate and reliable results."), *aff'd sub nom. Consolidated Rail Corp. v. United States,* 855 F.2d 78 (3rd Cir. 1988).

Most if not all other Commissions and courts have agreed that replacement costs are an infeasible method of measuring the value of regulated assets. These regulators have been persuaded by the reasoning of Justice Brandeis in *Missouri ex rel. Public Service Comm'n v. Southwestern Bell Tel. Co.,* 262 U.S. 276, 289-312 (1923) (Brandeis and Holmes, JJ., concurring in the result, but dissenting "fundamentally" on the "rule to be applied"), *followed in FPC v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944); *see also* Alfred E. Kahn, *The Economics of*

Regulation (MIT Press, 1988 ed.) at 39 & n.40 (according Justice Brandeis a "place of high honor" for his famous opinion in the *Southwestern Bell Tel. Co.* case).

The Railroads' position is reminiscent of that of Enron, which until 2001 pushed for the use of "mark to market" accounting. That form of accounting used its own models to drive up asset values on speculative claims that were found to be unsubstantiated and indefensible, ultimately causing the collapse of Enron. The STB should learn from that history, and keep the Railroads on their traditional "book" accounting, so as to avoid in the railroad industry the types of problems Enron brought to the electricity industry.

We see nothing in the Railroads' voluminous Petition and accompanying Exhibits that solves these problems. Rather, through the sheer weight of consultants' testimony, studies, and exhibits, and by converting their recommended approach to a mathematical exercise (thereby "implying certitude," as Justice Brandeis wrote, 262 U.S. at 299), the Railroads attempt to convince the Board and affected community of interests that their approach is preferable to the generally prevailing approach of regulatory agencies in all regulated industries. It is folly to think that the Railroads have solved the problems associated with the use of replacement costs for existing assets. The Railroads' Petition is, therefore, a waste of time and resources and should be denied without the institution of a time-consuming and expensive rulemaking proceeding that will distract the Board, its staff, shippers, and the rest of affected community from addressing the real issues faced by the Board.

Argument

<u>The Issue Now Before the Board Is Not the Merits, But Whether to Institute a Proceeding.</u> EEI does not herein seek to respond comprehensively to the merits of the Railroads' lengthy Petition, because, under the Administrative Procedure Act ("APA"), the issue at this

stage is simply whether the STB should *institute* a rulemaking proceeding *to consider* the merits of the Railroads' Petition. 5 U.S.C. §§ 553(c), 706(d). EEI urges the Board *not* to institute rulemaking as the Railroads have requested, for several reasons, set out *infra.*

Moreover, the Railroads' Petition has obviously been in the works for several months, given its length and the substantial statements of consultants attached thereto; it would be unreasonable to expect any party to respond to all of the Railroads' arguments and evidence within 20 days.

There Is No Applicable Precedent for the Use of Replacement Costs to Value Existing Regulated Assets. No other regulator in the United States of which EEI is aware uses a replacement-cost methodology to value the assets of the regulated entity for purposes of determining the adequacy of the regulated entity's earnings, nor does the Petition cite any such use. The Supreme Court has held that the Constitution is satisfied if the assets devoted by the regulated entity to the business being regulated are valued on an actual-cost basis, rather than on a replacement-cost basis. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (following Justice Brandeis's famous opinion in *Southwestern Bell Tel. Co., supra,* 262 U.S. at 289-312). In his famous opinion, Justice Brandeis set out in great detail and with enormously compelling logic the folly of attempting to determine non-book values for the assets of regulated entities, and concluded that the best methodology to use is original cost (minus depreciation, but plus improvements, of course), sometimes referred to as "net investment."

EEI discussed this subject at some length in the undersigned's Testimony (at 14-15) filed April 17, 2008 on behalf of EEI in Ex Parte No. 677, *Common Carrier Obligation of Railroads.* EEI respectfully refers the Board to that Testimony and incorporates it by reference herein. EEI's Testimony describes (for regulated entities generally) an effort that was made, beginning with *Smyth v. Ames*, 169 U.S. 466 (1898) and ending with *FPC v. Hope Natural Gas Co., supra*, to assess the value periodically of ***each asset*** devoted to the business of the regulated entity.

The ICC Decided *Not* to Adopt a Replacement-Cost Methodology Because It Was Infeasible. The Petition acknowledges (at 7-8) that the ICC has previously not adopted a replacement-cost methodology for revenue adequacy purposes because it was considered infeasible to implement. *Standards for Railroad Revenue Adequacy*, Ex Parte No. 393 (Sub-No. 1), 3 I.C.C.2d 261, 277 (1986)("While current cost accounting is theoretically preferable to original cost valuation, it cannot be practically implemented in a manner that we can be confident would produce accurate and reliable results."), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 855 F.2d 78 (3rd Cir. 1988). EEI still believes it to be infeasible to assess accurately (let alone annually) the value of railroad assets, which assets are prudently maintained as part of the Railroads' systems, and the liabilities associated with those prudently retained assets.[2]

The wisdom of Justice Brandeis's (and Justice Holmes') views in *Southwestern Bell Tel. Co.* persuaded the Court to abandon the market-value approach when it decided *FPC v. Hope Natural Gas Co.* While the Railroads now claim (Petition at 22-36) to have created and proposed a simplified replacement-cost methodology that would be feasible to apply, history teaches that the Railroads' claims are highly likely to be incorrect. *See, e.g.*, Alfred E. Kahn, *The Principles of Regulation* (MIT Press, 1988 ed.) at 39 & n.40 (according Justice Brandeis a "place of high honor" for his *Southwestern Bell Tel. Co.* dissent). The net-investment methodology generally has been followed since *Hope Natural Gas Co.*

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[2] Professor Kahn explained the matter this way: "[A] strong economic case can be made for basing rate levels on 'the present as compared with the original cost of construction,' as *Smyth v. Ames* suggested. But as it developed in practice it had a fatal flaw: it invited endless controversy over the proper valuation of sunk capital...." *The Economics of Regulation* (MIT Press, 1988 ed.) at 39.

Here, by contrast, the STB is being requested to adopt *a methodology* for determining replacement-cost values *by rule*. While a mathematical formula approach generally may appear to be accurate,[3] in fact the determination of asset values, system-wide, on a replacement-cost basis, is extraordinarily difficult and unprecedented. Anyone who owns a home or other real estate, or even an automobile, knows how much imprecision there is in determining the values of such property. Doing so for railroad assets (whether real property or equipment), most of which (unlike most homes) have not been bought or sold, or at least have not been bought or sold individually for many decades, would be highly subjective.

In recent years, of course, most Class I railroads have acquired all or a substantial part of other railroads Most if not all of those transactions included payment of an acquisition premium over the market value of the acquired railroad's equity. Accordingly, those transactions were not based on book values, nor (because entire railroads were acquired) did they produce accurate market values or replacement costs for the individual assets involved. Over the objections of shippers, the ICC and STB have already included those acquisition premiums on the railroads' books for regulatory purposes. *E.g., Erie-Niagara Rail Steering Committee, et al. v. STB*, 247 F.3d 437, 442-43 (2nd Cir. 2001). Accordingly, the inclusion of those acquisition premiums already may have accomplished a substantial part of the Railroads' goal of having the STB restate the cost of railroad assets to more current values for regulatory purposes.

A fortiori, measuring replacement costs year-after-year for railroad assets (whether by the STB or the Railroads) would only perpetuate the initial inaccuracies, whether on the high or low side of the correct amounts, because the almost certainly erroneous starting values of Railroad assets would be the bases for subsequent, inflation-adjusted valuations of the same assets.

[3] As Justice Brandeis put it so well in his *Southwestern Bell Tel. Co.* dissent: "The engineer spoke in figures – a language implying certitude." 262 U.S. at 299.

The Matter Is Committed to the Board's Discretion. Here, whether to grant the Railroads' Petition to institute rulemaking is a matter committed to the Board's discretion. *Arkansas Power & Light Co. v. ICC*, 725 F.2d 716, 723 (D.C. Cir. 1984)(scope of review of agency decision to deny a rulemaking petition "is *very narrow*"; Court "will compel an agency to institute rulemaking proceedings only in extremely rare instances")(emphasis in original). While the Railroads imply that the Board's adoption of the CAPM methodology for determining their annual, industry-wide, cost of capital *requires* the adoption of a replacement-cost methodology (Petition at 5-6), the Board did not so hold in its Decision in *Methodology to Be Employed in Determining the Railroad Industry's Cost of Capital*, Ex Parte No. 664 (served August 20, 2007), slip op. at 9, and the Railroads have not sought judicial review of that Decision, on that basis or any other Decision in Ex Parte No. 664.

Use of Replacement Costs Would Require the Board to Adopt a New Methodology for Determining the Cost of Capital, So As to Not Double-Count for Inflation. There is no authority for the proposition that the CAPM methodology necessarily requires the use of replacement costs to value a regulated entity's assets. Indeed, if replacement costs were used, it would be necessary to *replace* the STB's just-adopted cost-of-capital methodology with a methodology to determine the *real*, not the *nominal*, cost of capital, so as not to double-count for inflation (and thereby overstate the Railroads' need for capital).

Adoption of a Replacement-Cost Methodology Would Require Substantial Resources on an Ongoing Basis. The Board would have to devote substantial resources to the development of such a replacement-cost methodology, not only first to decide whether to employ it, but thereafter annually to determine whether, *inter alia*, (a) the Railroads' assets are prudently[4] being

[4] Justice Brandeis explained the "prudent investment" doctrine as well in his opinion. *Southwestern Bell Tel. Co.*, 262 U.S. at 289 n.1.

maintained in rail service regulated by the Board, (b) the replacement cost of the Railroads' assets, which assets should not be considered appropriate to retain, and (c) such other intangible matters as the possible present and future environmental liabilities associated with those assets. Such an annual exercise to determine which railroad assets are useful parts of the ongoing business, and then to determine the replacement-cost values for those "prudent" assets, as well as the current amounts of liabilities associated with those assets, would be a considerable drain on the Board's and the parties' limited resources. As Justice Brandeis put it so eloquently in his *Southwestern Bell Tel. Co.* opinion (262 U.S. at 308):

> The direct expense to the [regulated entity] of maintaining an army of experts and of counsel is appalling. The indirect cost is far greater. The attention of officials high and low is, necessarily, diverted from the constructive tasks of efficient operation and of development. The public relations of the [regulated entity] to the community are apt to become more and more strained. And a victory for the utility, may in the end, prove more disastrous than defeat would have been. The community defeated, but unconvinced, remembers; and may refuse aid when the company has occasion later to require its consent or cooperation in the conduct and development of its enterprise.

As Justice Brandeis implied, shippers and other interested members of the public with an interest in the issues raised by the Railroads also would have to devote substantial resources to participate in this process on the merits, if a proceeding is instituted and comments are sought, including hiring economists and other experts as has been done by the Railroads. Such investments would be wasteful and should not be required if, in the end, the Board is to decide *not* to change or modify its revenue-adequacy rules.

"Competitive Market Principles" Do *Not* Require Use of Replacement Costs. Although the Railroads claim that "competitive market principles" (Petition at 1) substantiate the need for adoption of a replacement-cost methodology, all other regulated entities (including EEI's members) compete for capital in the same markets, but they are generally (if not universally) not regulated on a replacement-cost basis. Accordingly, it is clearly unnecessary that regulated entities be regulated on a replacement-cost basis in order to raise capital.

The Railroads' Approach Is Reminiscent of Enron. Enron pioneered the use of "mark to market" accounting for its assets, including those in its numerous partnerships. As we all know, Enron's aggressive strategy, especially including "mark to market" accounting using models to drive up asset values, ultimately proved to be the undoing of the company. The Board should learn the lessons of history and not permit the Railroads to go down the same path as Enron went down.

The Board Should Decide *Not* to Institute a Rulemaking Proceeding. Accordingly, rather than to proceed on the assumption that holding a proceeding such as that proposed by the Railroads' Petition may be useful, and therefore decide to commence a rulemaking proceeding (which, if it were later terminated without adopting rules, would be subject to judicial review under the "arbitrary and capricious" standard of 5 U.S.C. § 706, *Motor Vehicle Mfrs. Ass'n of America v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 & n.9 (1983)), the Board should consider now what difficulties are associated with the Railroads' Petition, for *all interested parties (including the Board), regardless of the merits of the Railroads' Petition,* and decline to commence a rulemaking proceeding as a matter of the Board's discretion.

EEI does not believe the Railroads' Petition has substantial merit. However, even assuming *arguendo* that the Board believes it may have merit, EEI believes that the Board should, in the sound exercise of its discretion, conclude (as it did in Ex Parte No. 393 (Sub-No. 1)) that the practical difficulties associated with the type of exercise proposed by the Railroads are such that it should not subject interested parties to the substantial investment of time and resources that a rulemaking proceeding on this subject would entail. EEI participated in prior rulemaking proceedings conducted by the ICC to establish the current revenue-adequacy standards, and those proceedings took years, and massive investments by interested parties, to produce the current standards.[5] Proceeding down the same path, without any likely prospect that, in the end, the Board will adopt a replacement-cost approach to asset valuation, would itself be extremely wasteful and unnecessary.

Conclusion

For the foregoing reasons, EEI urges the Board not to institute a rulemaking proceeding, as requested by the Railroads, to value rail assets using a replacement-cost methodology.

Respectfully submitted,

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[5] In Ex Parte No. 393 (Sub-No. 1), the ICC reopened its prior Ex Parte No. 393 proceeding to reconsider the standards adopted therein. After years of effort, and massive investments of resources by the interested parties, including EEI, the ICC made only one change to its standards, and decided not to adopt a replacement-cost standard for asset valuation. 3 I.C.C.2d at 277.